

Leithner Letter No. 124-126

26 April - 26 June 2010

Economics can predict the effects to be expected from resorting to definite measures of economic policies. It can answer the question whether a definite policy is able to attain the ends aimed at and, if the answer is in the negative, what its real effects will be. But, of course, this prediction can be only "qualitative." It cannot be "quantitative" as there are no constant relations between the factors and effects concerned. The practical value of economics is to be seen in this neatly circumscribed power of predicting the outcome of definite measures.

Ludwig von Mises
The Ultimate Foundation of Economic Science (1962)

FORBES: *So are people being fooled by the stock market rally?*

RON PAUL: *Well, not the people who are making money. They love it. But they're going to get caught. It's another mini-bubble that's forming; it's not the fact that we're back on course again. Just think of all the liquidity and all the money pumped into this system. So it's starting to flow back into the stock market. Stocks are going up and somebody's going to get a little nervous and start selling and then you'll see it go down again. Markets are more powerful than the economic planners, so I think there will be another sharp sell-off again.*

I don't think this economy has picked up. No, it really hasn't. We keep doing the wrong things. We have a housing crisis because we had way too many houses and the prices were too high. The policy in Washington today is to prop up the price of housing and to build more houses. And you want the prices of houses to go down as fast and as far as possible so people will start buying them again. And you want to take a rest on building houses because we have a couple billion houses too many. And it's all out of balance. And I lay that at the doorstep of the Fed, because even though congressional policies have a lot to do with this, it's the Fed's creation of credit and artificially low interest rates that produces the bubble.

[Ron Paul's Golden Rule](#)
Forbes (8 January 2010)

Investors, Beware: the Crowd Is Confident

On 30 December 2008, when the All Ordinaries Index (AOI) stood at 3,638, *The Weekend Australian* asked a group (comprised mostly of funds managers and stock brokers, but including the head of the Australian Psychics' Association) to predict its level – as well as that of the Dow Jones Industrial Average (DJIA), the price of an ounce of gold and a barrel of oil, the RBA's overnight cash rate and the \$A-\$US exchange rate – one year hence. The most bullish member of the panel prophesied that the AOI would rise by 38% to 5,037; the most bearish forecast that it would fall by 12% to 3,200; and the mean of their predictions was a rise to 4,367. As *The Weekend Australian* (16-17 January 2010) put it, “at a time when the sky appeared to be falling, our panel held its nerve and predicted the market would recover to the tune of 20% in calendar 2009.” Funds managers are normally a bullish bunch;¹ accordingly, their predictions tend to be overly optimistic. In late 2008, however, they weren't exuberant enough: on 31 December 2009, the All Ordinaries Index closed at 4,882 – a rise of more than 33% during the year.²

Early in January of this year, *The Weekend Australian* asked another group (whose membership overlapped heavily with the previous year's) to predict the level of the AOI, DJIA, etc., at the end of 2010. The most bullish member of the group predicted that it would climb to 5,800; the most bearish (who was also the most pessimistic at the end of 2008) predicted that it would fall to 4,417; and the mean prediction was a rise to 5,317. As *The Weekend Australian* (16-17 January 2010) put it, “having slightly underestimated the extent of the 2009 share market recovery, the panel predicts an average 12% gain for the All Ordinaries Index, with the Dow tipped to add a further 8%.” “Overall,” the article concluded, “the message from the ether is encouraging. ‘Generally speaking I feel things are likely to improve,’ says Australian Psychics' Association head Simon Turnbull.”

¹ Chap. 4 of David Dreman, *Contrarian Investment Strategies: The Next Generation* (Simon & Schuster, 1998) provides a somewhat dated but very thorough and readable overview of research in this field.

² The panel's other predictions were bullish, but not bullish enough. At the end of 2008, for example, the DJIA stood at 8,483; the average prediction for its close at the end of 2009 was 9,509; and its actual close at the end of December 2009 was 10,458. The average prediction thus undershot the target by 12%. Similarly, at the end of 2008 the price of oil stood at \$US40; the average predicted price at the end of 2009 was \$62; and its actual close was \$US79. That's an “under prediction” of 46%. In two of the five categories, the prediction of the head of the Australian Psychics' Association was closer to the mark than the average prediction of the group.

	Actual Result	Group Prediction	Group v. Actual	Psychic's Prediction	Psychic v. Actual
All Ords	+34%	+20%	-14%	+6%	-28%
Dow Jones	+24%	+12%	-12%	+9%	-15%
\$A-\$US Exch Rate	+31%	+6%	-28%	+13%	-18%
Gold (\$US)	+24%	-2%	-26%	+5%	-19%
Oil (\$US)	+98%	+55%	-46%	0%	-98%

Others are even more confident. “Australian shares are expected to show robust gains in 2010, building on this year’s spectacular market recovery, as the economy returns to trend growth and corporate profits improve,” [Reuters reported on 24 December](#). “Stronger demand for resources from Australia’s largest trading partner China [which pipped Japan at the post late in 2008] and an increase in mining-related services will underpin further gains for equities ... We are very linked to the Asian recovery and China, particularly for [sic] the diversified miners.” Indeed, “We’ve only started to price in the very, very early part of an earnings recovery. We’ve got to the point where the market is fair value, but it has yet to discount any genuine improvement in earnings in the Australian economy.” For 2010, the “S&P/ASX index” (the article didn’t say which one) is “forecast to jump almost 16% from the 31 December [2009] close to end the year at 5,500. Estimates range from 3,700 to 6,300.”

Yet others are still more cheerful. *The Australian* ([Share Market Set to Gain 19% in 2010](#), 24 December) reported “the share market is expected to lift by up to 19% in 2010, after posting its best gains in 16 years [in 2009], as the domestic economy continues its recovery from the global financial crisis.” According to one well-known “strategist,” “we’re looking for the S&P/ASX200 index to reach 5,300 points by mid-year and 5,600 by the end of the year.” Three of the article’s contentions are particularly noteworthy. First, the “current bull market phase will be driven by corporate earnings growth;” second, “the domestic economic recovery has a lot further to go;” and third, “[these two factors], combined with the fact that interest rates are still relatively low and there is a lot of cash sitting on the sidelines, [implies that] there’s plenty of fuel to push the market higher ... In Australia, the economy is being driven by China and strong population growth.”

It’s not just brokers, analysts and funds managers: Australians as a whole once again exude confidence. As *The Australian* reported ([Consumer Confidence Nears Peak of 2007 Mining Boom](#), 21 January), “the measure of consumer confidence compiled by the Melbourne Institute and Westpac rose 5.6% in January to 120.1 points, close to the peak reached in 2007 when the mining boom was at full strength.” Further, “for homebuyers, the threat of higher interest rates was outweighed by the promise of rising house prices ... their index reading of 127.3 points was the highest since the Melbourne Institute started assessing the views of different household groups in 1994.” 84% of Australians think that the prices of houses will rise in the next twelve months; of these, 21% believe that prices will rise by 10% or more. Finally, “the Reserve Bank ... said in its last review of the economy published in November: ‘The recent recovery in confidence may partly reflect a sense of relief that the very bad outcomes thought possible earlier in the year have not materialised.’”

Some Sceptical Reactions to These Confident Assertions

How sensible are these expectations? Is the All Ordinaries Index reasonably valued? Is it prudent to suppose that it will, for the second year in succession, rise by a double-digit percentage? Are corporate earnings really improving (or on the

verge of improving)? Is it logical to anticipate that strong growth in China will underwrite hefty gains on the ASX? As a first point, it's worth comparing the aforementioned predictions about the Australian stock market during 2009 to a couple of passages in [Letter 114-116](#) (26 June-26 August 2009). On p. 20 I stated:

These two sets of assumptions yield nine estimates of the AOI's "fair value." If earnings fall to their long-term trend and a bearish multiple emerges, then the All Ords' fair value is 1,688 – roughly half the level of its low in March 2009. If earnings remain constant and the "bullish" multiple suddenly prevails, then fair value is 5,512 – a modest 67% above the March trough. Mid-range assumptions with respect to both earnings and the multiple generate an estimate of 3,127 – just below the March low.

And on p. 22 I concluded:

Given how we came to this pass, where Australia now stands, what the government is doing to us and what may lie before us, it's difficult to conclude that stocks are cheap and easy to believe that they remain dear. True, the AOI is less overvalued now than it was, but "less overvalued" is not the same as "undervalued." Accordingly, Leithner & Co.'s plans include the possibility that an environment marked by recession and stagflation (like the one that plagued the early 1970s to the mid-1980s) prevails during the next several years. In such a climate, the fair value of the All Ordinaries Index would be ca. 1,700-2,300. That implies a fall of ca. 70% from the Great Bubble's maximum and the harshest bear market in Australian history.

These passages provided general cautions rather than specific predictions; clearly, however, market levels such as these didn't transpire during 2009. Are the passages simply wrong? Obviously, that's possible; upon reflection, however, I remain unrevised and unrepentant. In Leithner & Co.'s Annual Report 2006-2007, prepared just as the "Global Financial Crisis" began to erupt, I wrote:

Today's bulls, like all enthusiasts at all times, care nothing about history's "base rate" and everything about today's "case rate." They believe either that (a) because they're happening now, Good Things must continue to occur; or (b) because they haven't happened in a very long time, Bad Things can't possibly recur. Chris sounds like a broken record, but his fundamental point is hard to muffle: the phenomenal results of the past five years imply much more pedestrian results, and perhaps worse, during the next five years [see also [Golden Era or Gilded Age? Inflation and Mean Regression in Australian Stock and Bond Markets, 1965-2006 – and Some Base Rates for 2007-2011](#)]. Yesterday's Fed Chairman (and the architect of many of tomorrow's misfortunes), Alan Greenspan, agrees. Now that he no longer sits in The Big Chair, he's willing to tell us what he really thinks. On 23 May he told Reuters "in the last five years, the world as a whole [has grown] faster than at any time in the world's history. It can't last and it won't last because it's a one-shot adjustment." Since 2003, Chris's dour outlook has clearly been wrong. But if it transpires that we don't live in a New Era after all, and that [[Sir Francis Galton's insight regarding regression towards the mean](#)] remains valid, then Chris won't have been mistaken: he'll simply have been premature.

Predicting the All Ords' Annual Return Using a One-Parameter Regression Model

How reasonable are today's "consensus" expectations about the course of the All Ordinaries Index during 2010? For the moment, let's assume that we know nothing other than the changes of the AOI on a 12-month basis since 1874. (Although it was created in 1980, it can be extrapolated back into the 19th century.) Its best-ever return (82.2%) occurred in the twelve months to September 1987, and its worst-ever return (-45.7%) punctuated the year to December 2008. Since 1875, the mean 12-month return has been 6.17% and the median 6.35%. (These returns include neither the cost of buying and selling securities nor the other expenses typically incurred by large investment managers, or distributions and dividends.) In other words, if we have nothing other than these data at our disposal, and if we're willing to make some unrealistic assumptions (see below) and also to assume that these assumptions will hold in the future, then our best guess about the AOI's return during the next 12 months – indeed, our best guess about its return in any 12-month period – is ca. 6.25%. That's a far cry from the expectations of the funds managers, strategists, psychics, *et al.*, cited by Reuters and *The Australian*. Is irrational exuberance once again rearing its ugly head?

So much for the central tendency of returns. What about their variability? To answer this question, let's compute the 12-month returns of the AOI for each month since December 1875 (i.e., the intervals January 1875-December 1875, February 1875-January 1876, ... December 2008-November 2009 and January 2009-December 2009) and then rank them from lowest to highest. Let's then separate this ordered list of 12-month returns into five groups of equal size ("quintiles"), where Quintile A contains the lowest 20% of observations ... and Quintile E contains the highest 20%. We can then compute the mean and median of each quintile.³ The results of this exercise appear in Table 1 (see also Leithner & Co.'s [Objectives and Possible Returns](#), pp. 3-6).

Assuming that these observations are roughly normally and independently distributed,⁴ and assuming that 12-month returns will in the future continue to derive from a distribution with the same central tendency and dispersion, we can infer that there's a one-in-five chance that the return in any randomly-selected 12-month interval will be minus 5.15% or less. (The probability that a loss occurs is 29.0%.) Similarly, there's a one-in-five chance that any future 12-month return will be 16.47% or more; and there is a three-in-five chance that it will be greater than

³ For further details of this method, which has a rather long history in financial analysis, see Francis Nicholson, "Price-Earnings Ratios in Relation to Investment Results," *Financial Analysts Journal* (January-February 1968); David Dreman, *Contrarian Investment Strategies: The Next Generation* (Simon & Schuster, 1998); and James P. O'Shaughnessy, *What Works on Wall Street* (McGraw-Hill, 1998).

⁴ Alas, these observations are only roughly normally distributed; that is, the distribution has [fat tails](#). Further, the observations are not independently distributed: they exhibit negative serial correlation. In plain English, an above average result in a given year is likely to be followed by a below-average result in the next year. Note that the AOI rose 33% in 2009 (i.e., fell into Quadrant E of Table 1). Accordingly, given the returns' negative serial correlation, chances are higher than average that the All Ords' return in 2010 will *not* fall into Quadrant E.

minus 5.14% and less than 16.44%. In Australia, then, steep losses over short intervals are not remarkable; nor are hefty gains. Results can and usually do vary considerably from one year to the next.

Table 1: Twelve-Month Returns, All Ordinaries Index, 1875-2009

Quintile	Range of Returns	Mean	Median
A (Lowest 20%)	from -45.7% to -5.15%	-14.93%	-11.88%
B (Next Lowest 20%)	from -5.14% to 3.43%	-0.23%	0.11%
C (Middle 20%)	from 3.45% to 8.80%	6.18%	6.38%
D (Next Highest 20%)	from 8.82% to 16.44%	12.12%	12.10%
E (Highest 20%)	from 16.47% to 82.16%	28.09%	24.01%

Continuing to assume that the observations are independently distributed, how likely is it that a return in one year of 33% (as in 2009) will be followed by a return of 19% (as predicted by some prominent “strategists” for 2010)? How likely, in other words, is it that a return for one year will fall into Quadrant E, and that the return in the next year will also fall into Quadrant E? The probability is $0.20 \cdot 0.20 = 0.04$ or 4%. In other words, two results in succession so greatly above the average occur only once every 20 years or so. Clearly, if the central tendency and variability of Australian stock market returns since the 1870s is our only source of information, the odds are rather strongly against today’s confident crowd.

Have Australian Corporate Earnings “Recovered”?

Equally clearly, we have more information. The trouble, though, is that the “noise” of expectations often shrouds the “signal” of information. Reflecting the general bonhomie that presently pervades the country, on 18 January *The Australian* ([Buoyant Reporting Season on the Way](#)) reported “almost a year on from the share market bottoming, Australian investors are about to see the benefits of what is commonly known as the ‘sweet spot’ in financial circles. Analysts are predicting a solid reporting season for local companies due to the powerful combination of a swifter than expected economic recovery, extensive cost cutting and below average interest rates throughout 2009 ... Earnings upgrades from companies such as Qantas and the Commonwealth Bank, as well as a strong fourth-quarter production report from miner Rio Tinto ahead of its full-year results in March, have helped cement a widespread belief that the worst of the global financial crisis is over.”⁵

⁵ [Last Year’s Raisings About to Inflict Pain](#) (*The Weekend Australian*, 23-24 January) is much more sensible. “The good news,” it notes, “is Australian corporate profits rose in the last half, but perhaps the untold story of the coming profit season will be the overwhelming evidence of the massive dilution inflicted on shareholders by last year’s capital raisings.” If the forecast it cites (namely that corporate profits will grow by 7% but earnings per share will fall by 17%) is accurate, then the earnings of the All Ordinaries Index will fall from the current (end of December 2009) \$311 to ca. \$258 (see Figures 1 and 2). “Last year the entire Australian stock market had the equivalent of a one-for-nine rights issue, with more than \$90 billion in equity raised – much at bargain basement prices, reflecting desperation by corporate boards fearing the worst from the financial crisis. It is easy to be wise in hindsight, and many smart people ... warn there may be another fall, but there’s no denying

Soft words about the future provide one way of looking at things. Hard data about the past and present provide another. In [Letter 114-116](#) (see in particular Figures 4-5) I asked: do corporate earnings indefinitely grow? Or do they ebb and flow? Analysis of relevant data told us five things about the “raw” (that is, unadjusted for the Consumer Price Index) earnings of the AOI:

1. As a rule, they rise: their trend since 1974 (the first year for which I’ve found valid and reliable data) has an upward slope.
2. Over shorter periods they can rise much more rapidly than – and thus rise considerably above – the overall trend.
3. What goes up eventually comes down. Yes, earnings typically rise year after year; but they can also fall sharply for several years in succession and thereby retrace much or all of their previous gain. Earnings, in other words, can also fall below their long-term trend. What causes earnings to plunge below trend? More than anything, recessions do.
4. Phoenix rises from the ashes. True, recessions raze earnings. But the fire-storm eventually passes, green shoots appear and thicken, and earnings resume their upward march.
5. Over the decades “raw” earnings don’t grow without interruption: they ebb and flow at various speeds along a modestly upward long-term trajectory.

Since 1974 earnings have risen above and below – but have always regressed back to – their long-term trend. They can and do increase above the trend; but when they do, they eventually fall back to it. Equally, they can and do collapse below the trend; but when they do, they eventually increase back to it. Figure 1, which updates the data in Figure 4 of [Letter 114-116](#), indicates that during 2009 the earnings of the companies comprising the All Ordinaries Index regressed towards their trend for the period 1974-2003. To make sense of the underlying concept (it is usually applied to individual companies, and sometimes to a sector of a market, but infrequently to an entire market), regard the companies comprising the AOI in a given year as if they were a single firm. During 1974, “All Ordinaries Ltd” earned profits of \$33.97 per share; and by 2008, its earnings had grown to \$458.14 per share.

The “predicted earnings” in Figure 1 ignore the explosion of profits after 2003, and answer the question: “if the trend from 1974 to 2003 once again prevailed, what level of earnings could we expect during the next decade?” In effect, I have drawn a best-fitting (“regression”) line through the earnings observed from 1974 to 2003, and then extrapolated this line into the future. On p. 12 of Letter 114-116

the deep hole directors have dug for their shareholders.” EPS, the article also notes, has long been seen as a good proxy for corporate performance “because it measures shareholders’ share of the action. This time around we will be told to focus on underlying, or real, earnings or to look more for the coming change to provide a much better barometer of the best stocks to follow. That may be true from a short-term investment perspective, particularly now, in what is seen to be a stock pickers’ market, but as a measure of long-term performance it is nonsense.”

I wrote: “if this long-term trend reasserts itself, then the earnings of All Ordinaries Ltd will fall by more than half (i.e., by 55%) from the average level attained in 2008. As the recession of the early 1990s reminds us, such a decrease has a relatively recent precedent. Further, if we are indeed in the midst of the worst crisis since the 1930s and a severe recession beckons, then such a sharp drop of earnings is hardly outside the bounds of possibility.”

Figure 1: The All Ordinaries’ Earnings per Share, 1974-2009 – See If You Can Spot the Deflating Bubble

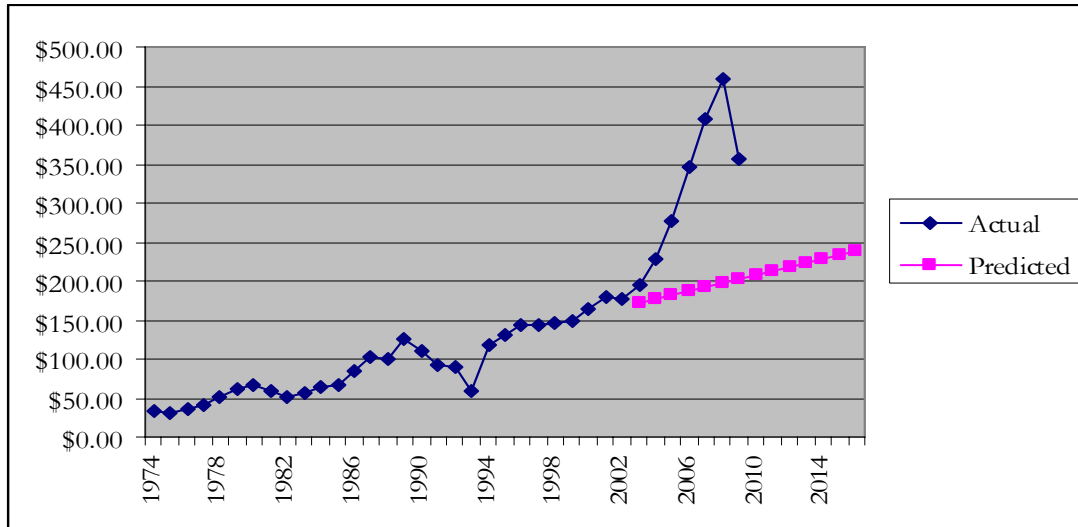


Figure 2: The All Ordinaries’ Rising and Falling Earnings per Share, 2007-2009

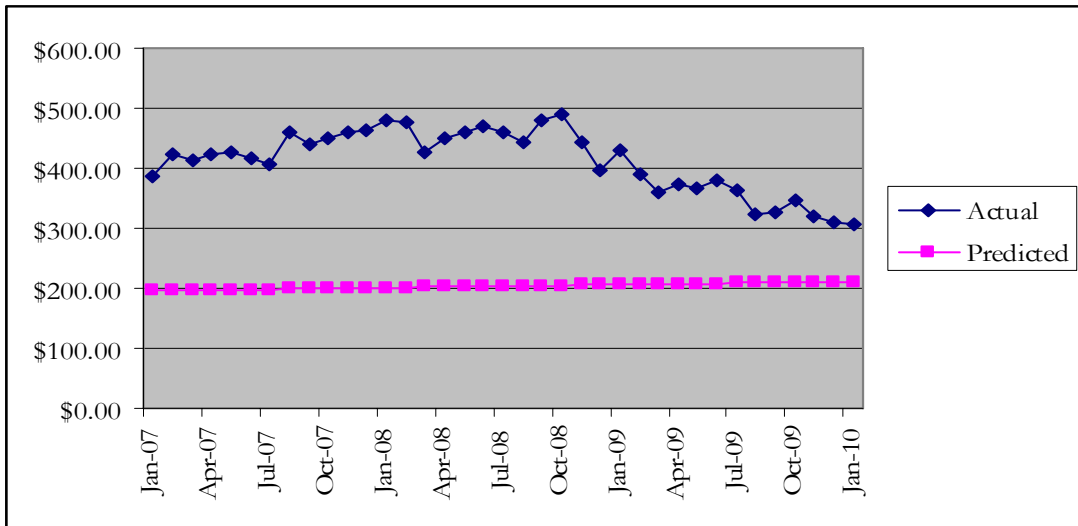


Figure 2 provides more detailed information about the course of AOI’s earnings during the past two years. They grew steadily, from \$385.35 in January 2007 to \$489.22 in October 2008. That’s an increase of 27%. Since then, earnings have fallen almost without interruption, to \$311.60 in December 2009 (they fell to just above \$300 in January 2010). That’s a decrease of 36% from the peak in October 2008, and it’s possible that they’ll fall to ca. \$250 during 2010 (see footnote 5).

Compare the present earnings of ca. \$300 to the data in Figure 1: since reaching their peak earnings have retraced roughly half of the distance back to their long-term trend.

So much for the AOP's earnings per share; what about the numerator of this fraction? Speaking to *The Financial Times* on 24 December 2009, Andrew Smithers (author of *Valuing Wall Street: Protecting Wealth in Turbulent Times*, McGraw-Hill, 2000 and *Wall Street Revalued: Imperfect Markets and Inept Central Bankers*, John Wiley & Sons, 2009) uttered words that should (but probably won't) give the Australian bulls pause. The points he raises apply every bit as much to Australia as they do to the U.S. Corporate profits are likely to disappoint over the next few years because profit margins are likely to shrink – that is, regress towards their historical means. “U.S. profit margins are at record levels,” Smithers said. “This is unusual for a recession and will no doubt produce claims that ‘this time it’s different’ and that profit margins are not reverting but have moved to a permanently higher level. While almost anything is possible in economics, this seems extremely unlikely and a bad bet for investors to make” (see also [Letter 96-98](#)).

Has the Australian Market Really “Recovered”?

What do the words “recovery” and “recovered” mean, anyway? According to my dictionary, recovery means (among other things) “the act or power of regaining, retaking, reclaiming or conquering again.” Hence a victim of theft offers a reward in order to recover his stolen goods. Recovery also means “getting well again, coming to or bringing back to consciousness, reviving a person from weakness, etc.” A third meaning is “a regaining of balance, of former position or condition, etc., a return to soundness.” Once these things have occurred, the person or thing in question has recovered.

Do you see the ambiguity? “Recovery” can but need not mean the return to the *status quo ex ante*. He whose car has been stolen might recover the vehicle; but after the thieves’ joyride, is it in the same condition as it was before the theft? Does an athlete who injures his knee ever truly recover? Has he recovered when he is able to leave his bed? Regain his feet and walk unaided? Return to the playing field? Or all of these things – plus use his knee as well as he could before his injury? That’s a rather severe definition of the process (recovery) and the terminus (recovered). A much more accommodating conception – and one which most of today’s crowd seems to have in mind – is that “recovery” means “cessation of deterioration.” Hence the owner of the car receives his car – with dents and smashed lights. It’s not in the same condition it was, but at least it’s in his garage. Similarly, the athlete returns to the pitch. True, he’s not as fast and agile as he was, but at least he’s playing. And a recovery on financial markets commences not when losses have been completely recouped but when “the worst is past.”

For the past couple of years, it seems to me, analysts, brokers, CEOs, journalists and others have used this phrase far too frequently and flippantly. The trouble is that – like the phrase “it’s different this time” – it’s heavily larded with wishful

thinking.⁶ It's a pity, but it's apparently true: no board of directors is going to pay a CEO to believe (and to act in expectation of) the worst. To utter this upbeat (or at least not downcast) phrase is usually to progress one's career. But prominent exceptions abound. Accordingly, "the worst is definitely behind us," Bear Stearns chief financial officer [Samuel Molinaro said in September 2007](#). Inconveniently for him, Bear collapsed in March 2008. "The problem ... is for the most part behind us," Merrill Lynch's CEO, John Thain, assured analysts in January 2008. Alas, within months he announced losses in the billions, and in September of that year Merrill was forced into the not completely willing arms of Bank of America.⁷ "The worst is behind us," Lehman Brothers chief [Richard Fuld told shareholders](#) on 15 April 2008. In June, the firm reported its worst-ever loss (\$2.8 billion), and on 15 September it sought bankruptcy protection.

Also beware the phalanx of economists-cum-cheerleaders who use this phrase like a pom-pom. "The worst is behind us as far as a market correction," [said David Lereah, chief economist for the National Association of Realtors](#), in 2006. "This is likely the trough for sales." Former Federal Reserve chairman Alan Greenspan and General Motors vice chairman Bob Lutz also declared in 2006 that the worst had passed. [Ken Lay, CEO of Enron Corp., resolved on 16 August 2001](#): "We have faced a number of challenges but the worst is behind us, and the business is doing great." Lay suffered many misfortunes, including a heart attack, after he uttered these fateful words. He died in July 2006, after conviction but before sentencing for fraud. The inescapable truth is that for some of us the worst is always ahead of us.

If the Australian market has "recovered," then have market participants recouped all of the losses they sustained from mid-2007 to early 2009? Perhaps some have; but it's much more likely that most haven't. Figure 3 compares Leithner & Co.'s results since its inception in 1999 to the All Ordinaries Accumulation Index and the Australian Bond Accumulation Index.⁸ A dollar invested in the AOI on 30 June 1999 grew to \$2.77 in June 2007, subsequently fell to \$1.65 on December

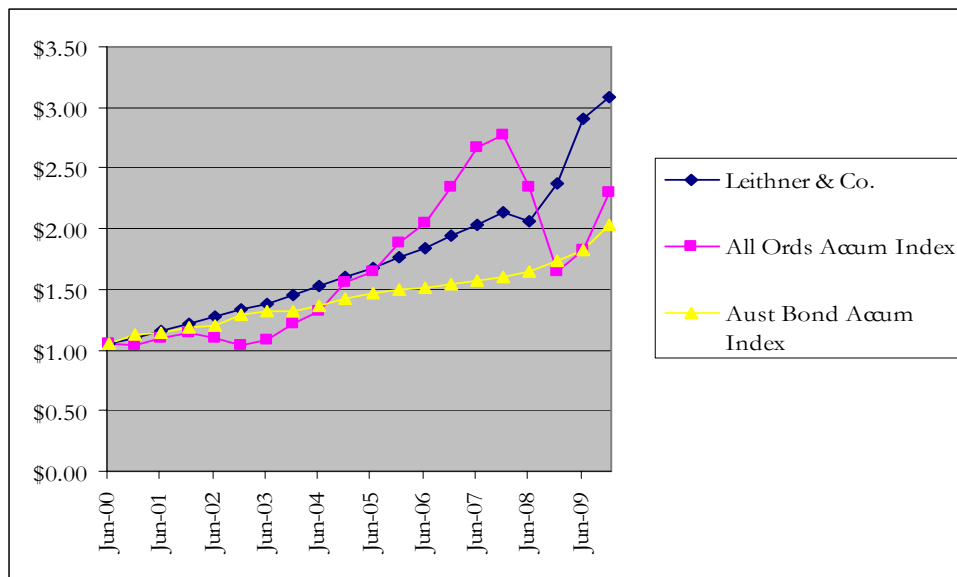
⁶ "The worst is behind us" is not just a wishful phrase: in the mouths of politicians, it can indicate desperation and the intention to deceive. In May 1974, during a runaway CPI and rampant unemployment – both of which would become worse before they got better – [President Richard Nixon uttered these infamous four words](#). [Mikhail Gorbachev repeated them in May 1986](#) when the casualties from Chernobyl tallied less than 10. (The [2005 report prepared by the Chernobyl Forum](#) attributed 56 direct deaths and an estimated 4,000 extra cancer deaths to the accident.) And guess what President Obama said in his [State of the Union](#) address on 27 January 2010? "One year ago ... we acted – immediately and aggressively. And one year later, the worst of the storm has passed."

⁷ Testimony to Congress by Bank of America's CEO, Kenneth Lewis, as well as internal emails released by the Oversight Committee of the U.S. House of Representatives, indicate that [Bank of America was threatened with the firings of its senior management and board](#), as well as strife with federal regulators, if Bank of America did not quickly acquire Merrill Lynch.

⁸ Based upon the All Ordinaries Index, which measures changes of the prices of the 500 largest companies listed on the Australian Securities Exchange, the All Ordinaries Accumulation Index (AOIA) measures the combined impact of changes in the prices of stocks and the receipt of dividends and other distributions. The Australian Bond Accumulation Index measures the returns of bond investments in an analogous way.

2008 and then rose to \$2.29 in December 2009. A loss of \$1.12 (that is, \$2.77 - \$1.65) occurred between June 2007 and December 2008; of that amount, \$0.64 (\$2.29 - \$1.65), was recouped in the year to December 2009. Sixty-four cents is 57% of \$1.12; hence for investors whose portfolios replicated the AOI, a bit more than half of the loss sustained in 2007-2008 had been recouped by December 2009. Assuming that these gains will be maintained, this is a recovery in the weak (“the worst is past”) sense of the term. But it’s not a recovery in the strong (return to the \$2.27 *status quo ex ante* of June 2007) sense of the term.

Figure 3:
Leithner & Co.’s Accumulation of Shareholders’ Capital since Inception
(versus Australian Shares and Bonds)



Three additional points are noteworthy. First, over the past decade and never mind the massive and relentless propaganda (“stocks are always the best-performing asset class over time,” “it’s not the timing of the market, it’s the time in the market,” etc.), Australian stocks have barely “outperformed” Australian bonds. Indeed, during certain sub-periods equity has underperformed debt. This is fundamental, yet few have come to terms with it (or even recognised it). Far more risky (in the conventional sense of the term, which refers to the volatility of their prices) assets – namely, shares – only modestly “outperformed” much less risky assets (namely, bonds). In this sense, the Australian “equities bubble” has not – yet? – burst. Secondly, the bulls should thank their lucky stars for the sharp rise of the ASX from March-December 2009. “Despite the near-miraculous recovery, our tipsters will be glad to leave behind the Noughties, which started with a tech stock crash and ended with a taste of near-apocalypse. We’re well ahead ... the market rose 50% over the decade. But this is a far cry from the 200% surge in the 1980s. And, had the market not recovered in the second half of [2009], the decade might have rivalled the worst ever, the 1880s, when the market fell 5%” (*The Weekend Australian*, 16-17 January 2010).

The third point is perhaps the most important. Perhaps I'm inattentive, but my strong impression is that funds managers' marketing materials DO NOT usually present results in a format like Figure 3. They do not take a dollar amount as a starting point, assume that this amount has been invested and compare it to the dollar amount that emerges after some period of time. Instead, they typically parade a series of percentage returns and compute an "average return" as if it were meaningful to the investor. Yet an average percentage return isn't really meaningful: quite the contrary, it can be downright misleading.

How so? Consider, as a very simple example, a two-year investment. Let's say that it gains 20% in its first year and then loses 20% in the second. What is the return on the investment? Many would say zero. The mean of these two percentages, after all, is $(20\% - 20\%)/2 = 0\%$. If you invest \$1, then during the first year your investment increases by 20%, such that at the end of the year you have \$1.20. During the second year, however, you lose 20% such that you have $\$1.20 \cdot (1 - 0.20) = \0.96 . In other words, you're not back to square one: you've lost an amount (\$0.04) equivalent to 4% of your initial investment. Your *average return* might be zero, but your *compound return* is negative. In the strict sense of the term, at the end of Year 2 your capital has not "recovered" to the level at which it began Year 1.

Note that in order to recoup the partial loss of an investment, one requires a greater positive return than the negative return that generated the loss. A loss of 20%, for example, requires a gain of 25% to offset the loss: $\$0.80 \cdot (1.25) = \1.00 . Further, the compound return from x periods of $y\%$ returns exceeds any other sequence that averages $y\%$. If, for example, you earn 5% per year for three years in succession, your simple average return is 5% and your compound return is also 5%. If, however, you earn 6% in the first year, 5% in the second and 4% in the third, your simple average return remains 5% but your compound return drops to 4.997%.

This is a minor difference; the point, however, is anything but insignificant. The greater the volatility of returns, the greater the drop in the compound return. If you earn 9% in the first year, 5% in the second and 1% in the third, your compound rate of return over the three years falls to 4.95%. And if you gain 10% in the first year, lose 10% in the second and gain 15% in the third, your average rate of return remains 5% but your compound rate of return falls to 4.42%. Why is this so important? *The greater the number of negative returns in a series of returns, and the more volatile the components of the series, the less meaningful and the more misleading is the average percentage return.* Recall from Table 1 that the All Ordinaries Index retreats, sometimes sharply, approximately 3 years out of every 10. Recall as well that the AOI's returns from year to year are typically quite volatile. This combination – a negative return roughly one-third of the time, plus volatile returns most of the time – conspire to compound your capital (expressed in dollars) at a much slower pace than the propaganda of the government and funds management industry (and the tyranny of average percentage returns) would have you believe.

Does a Perpetual Boom in China Mean an Extended Bull Market on the ASX?

One is tempted to infer from the daily torrent of forecasts (as well as from the flood of newspaper articles dutifully reporting these predictions) that the prices of stocks and bonds depend upon economic conditions. This assumed relationship takes two forms:

1. Stocks tend to rise when economic conditions *are perceived to be – or predicted to become* – strong and expected to remain robust.
2. The quicker (slower) is *the actual pace of economic growth*, the more (less) favourable is the investment climate and hence the bigger (smaller) is the harvest that investors can expect to reap.

To most people these hypotheses are obvious and indistinguishable. Indeed, they're so self-evident that the forecasting industry undertakes a constant, expensive and frantic search for new and ever more arcane "insights" into economic and financial market conditions, the relation of one to the other – and their course into the "foreseeable future." (By the way, precisely how far into the future can *you* foresee? So why on earth should you believe anything that anybody who uses this phrase says?) This industry – not to mention politicians and finance journalists – implicitly and sometimes overtly encourages people to believe that a booming economy necessarily begets favourable investing conditions.

Hence analysts, brokers, bureaucrats, CEOs and journalists have during the past few months lost no opportunity to hype the boom in China (which derives from its massive "stimulus") and its implications for Australia. ABC News ([Henry Sees Decades-Long Commodity Boom](#)), for example, reported on 22 October 2009: "it might be back to boom-town for Australia, with Treasury Secretary Ken Henry predicting a decades-long run of relatively high commodity prices. He is also forecasting a return to near full employment, although is less optimistic about the prospects for full Government coffers. 'It now appears that the impact of the global financial crisis on the Chinese economy and the Indian economy hasn't been nearly as large as many fear,' he said. 'It seems that that's likely to support high, relatively high commodity prices, that is prices for Australia's export commodities, for a considerable period of time, quite possibly ... for some decades.'"

The Australian ([Golden Age 'Will Stretch To 2050': Ken Henry](#), 23 October) went further: "Treasury chief Ken Henry has outlined a golden age for the Australian economy lasting to 2050 and beyond, as rapid population growth and Asian demand for resources bring a sustained surge of global investment. Dr Henry said the period ahead would impose great challenges on the government to pursue economic reform but 'with the right decisions, one can envisage a period of unprecedented prosperity' ... Evidence of China's effect on the economy came as departing BHP Billiton chairman Don Argus warned the Rudd government to keep Australia's mineral resources from being snatched by foreign state-owned entities. Both Ken Henry and Don Argus think this has a long way to go, based on growth in per capita commodity consumption. Said Ken Henry: 'China and

India are only in the early stages of catching up with the living standards of the developed world and this process could have a very long way to run.’ Said Don Argus: ‘I believe we stand at the threshold of an era of unprecedented growth [in Australia] due to demand generated by China and, in the future, India.’”⁹

According to “The Boom the West Has to Have” (*The Weekend Australian*, 14-15 November 2009), “[Western Australia] is in boom territory again, dragging the rest of the Australian economy along behind it as the state rushes to deliver its vast mineral and natural gas resources to China ... There’s new confidence about the state’s proximity to what really matters. It comes from knowing WA is more closely linked than any other state to the new centres of strategic and economic power in what is already being called the Asian century.” And on it went into 2010. On 18 January, *The Australian* ([Multi-Billion-Dollar Bonanza for Miners as Commodity Prices Push Forecasts Higher](#)) reported “the nation’s top miners stand to reap tens of billions of dollars in extra profit in coming years, with analysts boosting earnings and commodities forecasts because of surprisingly strong demand ... In a flurry of upgrades this year, bank analysts have boosted forecasts for mining commodities across the board on expectations of improved U.S. and European demand and China’s seemingly relentless growth.”

A boom in China and India, the crowd insists, means robust growth in Australia; and a growing Australian economy, it is equally convinced, guarantees a rising ASX. *Investors, beware: there are ample grounds to question and quite possibly to reject the claim that higher rates of economic growth inevitably cause the prices of stocks to rise.* There’s surprisingly little evidence that supports the general linkage between economic

⁹ By his own admission, the Secretary to the Treasury cannot tell us with any reliable degree of confidence the Commonwealth’s budget deficit, etc., in one and two years’ time. Yet he confidently foresees the course of economic developments decades into the future! Christina Romer, professor of economics at the University of California, Berkeley, reminds us (see Daniel Gross, [The Forecast of the Forecasters Is Dismal](#), *The New York Times*, 4 March 2007) that mainstream economists can’t predict recessions for the same reason that conventional stock market analysts can’t predict market crashes. “Both kinds of events, by their nature, are not predictable events.” Almost all the post-war recessions, she reckons, were preceded by a shock, like a spike in short-term interest rates, or a sharp rise in oil prices. “It’s impossible to see the shocks coming.” But if, as Romer rightly says, mainstream economists can’t reliably predict recessions, then how on earth can they reliably predict booms?

Similarly, meteorologists can tell us a fair bit about tomorrow’s weather, but hasten to add that forecasts of conditions more than 72 hours in advance are no more accurate than the toss of a coin. “Climate scientists,” however, are stridently confident about climatic conditions decades and even centuries into the future. In a long interview published in the *International Journal of Forecasting* (vol. 14, no. 3, 1 September 1998), [Arnold Zeller](#) of the University of Chicago, one of the giants in the development of econometric analysis, related an amusing story: “Steve Peck and I simulated the Federal Reserve-MIT-PENN econometric model of the US economy that had over 170 nonlinear equations. Our simulation experiments showed that the model had very strange properties that were unknown to the model builders. From these results we concluded that the model was not safe for use in analysing serious economic problems.” Generalising this point – mainstream economists and “climate scientists,” are you listening? – Zellner concluded: “I do not know of a complicated model in any area of science that performs well in explanation and prediction, and have challenged many audiences to give me examples. So far, I have not heard about a single one. Certainly the large scale econometric models and complicated VARs (very awful regressions) have not been very successful in explanation and prediction.”

growth and investment returns – and much that contradicts it. Elroy Dimson, Paul Marsh and Mike Staunton, for example, studied 16 countries' economies and stock markets during the past century (*The Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press, 2002). In each country, they found that returns on the stock market are either unrelated or inversely related with growth of GDP. The correlation is -0.27 for the period 1900-2000 and -0.03 for 1951-2000. Statistically, the rate of growth of GDP explained only about 7% of the fluctuation of stock returns between 1900 and 2000; and this key summary measure of economic conditions explained less than 1% of the variation of returns during the second half of the twentieth century.

A second analysis covers much longer periods of time than earlier research and analyses these periods in greater detail, but reaches the same conclusion. Jeremy Siegel (*Stocks for the Long Run: The Definitive Guide to Financial Market Returns and Long-Term Investment Strategies*, McGraw-Hill Trade, 2003) found that between 1970 and 1997 the average correlation between stock returns and GDP growth was -0.32 in 17 developed countries and -0.03 in 18 emerging markets. Thirdly, Jay Ritter ([Economic Growth and Equity Returns](#)), using the data assembled by Dimson, *et al.*, obtained a correlation of -0.42 for these 16 countries during the twentieth century (see also Alan Wood's column in *The Weekend Australian*, 17-18 July 2004). If anything, then, the more robust a country's overall rate of economic growth, the *lower* its stock market's subsequent rate of return (as these things are conventionally measured). As a rough rule of thumb, rates of growth explain between 1% and 18% of the variation in stock returns in these countries during the past century.

Ritter adds a caveat. In the short run (which seems to be one year or less), *unexpected* changes in the rate of growth do influence the prices of stocks. Prices decline when market participants suddenly anticipate a recession (or discover that a recession has begun) and they increase when investors abruptly sense a recovery (or realise that a recession has ended). Ritter believes that these cyclical or business cycle effects "should rationally have an effect on equity valuations, but the effects should be largely transitory." The effects associated with recessions "are partly due to higher risk aversion at the bottom of a recession, but also due partly to an irrational overreaction."

In a passage that would warm Ben Graham's heart and put a smile upon his face, Ritter says this "irrationality" generates short-term volatility "and mean reversion over multi-year horizons." According to Ritter, "whether the Chinese economy grows by 7% per year or by 3% per year for the foreseeable future [there's that phrase again!] is largely irrelevant for the future returns on Chinese stocks. There is also an asymmetry – if a country has negative growth, this is probably bad for stocks. But for positive rates of long-term growth, whether the growth rate is 3% or 7% shouldn't matter." Why does robust growth seem to *depress* returns? Jeremy Siegel hypothesises that, when they anticipate higher rates of growth, market participants pay higher prices for each dollar of anticipated profit and dividend. This depresses realised returns because more money must be invested today in order to

secure a given stream of earnings and dividends tomorrow. Hence the prescient headlines from *The Wall Street Journal*: “Dow 10,000 Means It’s Time to Prepare for the Hangover” (23 March 1999) and “Forget the Party Hats: Why Dow 10,000 Should Be No Cause for Celebration” (10 December 2003).

Ritter provides another clue to this puzzle. At any given point in time, certain industries are growing (indeed, some are expanding so quickly that they become regarded as the “industries of the future”) and others are declining. Some are shrinking in an absolute sense, and others are declining in a relative sense (i.e., growing more slowly than the overall economy). In Western countries, particularly the U.S., the twentieth century’s “growth” industries included motor cars, air transport, pharmaceuticals, computer hardware and software and biotechnology. Industries in decline included railways and tobacco. The airline industry has not made people rich; nor (during the past 30-40 years) have car manufacturers or biotech firms. Cigarette companies, on the other hand, have generated significant wealth for their shareholders (subject to the favourable settlement of unresolved lawsuits). So too have pharmaceutical firms.

“Growth industries” typically contain both successful and unsuccessful businesses; ditto declining industries. According to Ritter, companies earn profits only if entry into the industry is restricted and consumers and employees – including executives – do not expropriate these profits. Economic growth does not rebound to the benefit of shareholders unless the firms particularly affected by these developments possess enduring competitive advantages (which few do); and nations whose potential and actual economic growth is high do not offer attractive opportunities for investment unless the prices of assets in those countries are low relative to values (which they often aren’t). I doubt the bulls in Australia give a damn about such trivialities: they’re interested only in following booms. But how many realise that they well be chasing illusions?

America’s Financially and Economically Lost Decade

“In the current environment,” said James Glassman and Kevin Hassett (“Are Stocks Overvalued? Not a Chance,” *The Wall Street Journal*, 30 March 1998), “we are very comfortable both in holding stocks and in saying that pundits who claim the market is overvalued are foolish. Worries about overvaluation, we believe, are based on a serious and widespread misunderstanding of the returns and risks associated with equities.” A year later ([Stock Prices Are Still Far Too Low](#), *The Wall Street Journal*, 17 March 1999), they added “could it be that the model that Wall Street has been using to assess whether stocks are overvalued – a model based largely on historic price-earnings ratios – is deeply flawed? We think so. Investors are ignoring the old shibboleths and pricing companies like Gillette at a P/E of 64 or Microsoft at a P/E of 66. This reflects not their nuttiness but their sanity.”

Glassman and Hassett contended that market participants, from the humblest retail investor to the chairman of the Fed’s Open Market Committee, had long

misperceived stocks' risks. Traditionally, they were regarded as relatively risky securities relative to bonds; as such, they required a premium return ("equity premium") relative to allegedly "risk-free" securities such as government bonds. But if stocks and bonds were equally risky, as Glassman and Hassett believed, then the prevailing equity premium was far too high – and hence the prices of stocks far too low.

In their words:

Contrary to Alan Greenspan's famous warning – made on December 5, 1996, with the Dow at 6,437 – investors today [on 16 March 1999 the Dow Jones Industrial Average rose above 10,000 before closing at 9,930] are *rational* exuberant. They are bidding up the prices of stocks because stocks are a great deal. Dow 10,000 is just for starters. How high will the market go? We'll give you a hint: The title of our book, to be published this fall by Times Books, is *Dow 36,000*.¹⁰ Using sensible assumptions, we are comfortable with prices rising to three or four times their current levels. Our calculations show that with earnings growing in the long term at the same rate as the gross domestic product and Treasury bonds below 6 percent, a perfectly reasonable level for the Dow would be 36,000 – tomorrow, not 10 or 20 years from now [see also [The Atlantic Monthly](#) September 1999].

In the [letters section of the January 2000 issue of *The Atlantic Monthly*](#), Glassman and Hassett replied to a critic: "if the Dow is closer to 10,000 than to 36,000 ten years from now (i.e., if the Dow is below 23,000 in January 2010), we will each give \$1,000 to the charity of your choice." Clearly, Glassman and Hassett have lost their bet. The DJIA climbed to 11,750 in January 2000. After the collapse of the Dot Com Bubble and the attacks of 11 September 2001, it steadily fell and reached a low of 7,286 in October 2002. Although it recovered – in the strong sense of the term! – to a new record of 14,164 in October 2007, by the early months of 2009 it crashed back to the vicinity of 6,800. On the first business day of 2010 it opened at 10,428, and on 5 February it briefly fell below 10,000.

To put it mildly, the ten years to 31 December 2009 did not conform to the bullish consensus that prevailed on 1 January 2000.¹¹ According to Standard & Poor's, the decade just concluded has been American stocks' worst on record. Using total percentage returns (including dividends) as a yardstick, it's even been worse than the 1930s. In nominal terms, investors in the S&P 500 lost ca. 10% during the decade; net of CPI, they lost closer to 30%. (That's worse than the

¹⁰ In the book's introduction, Glassman and Hassett wrote "[we] will convince you of the single most important fact about stocks at the dawn of the twenty-first century: They are cheap ... If you are worried about missing the market's big move upward, you will discover that it is not too late. Stocks are now in the midst of a one-time-only rise to much higher ground – to the neighborhood of 36,000 on the Dow Jones Industrial Average."

¹¹ Clearly, a decade ago not everybody was wildly bullish. Robert Shiller, author of *Irrational Exuberance* (Princeton University Press, 1st ed., 2000) was perhaps the most prominent sceptic of that era. In "The New Dr Doom" (*Barron's*, 22 May 2000), for example, he stated: "the Dow could still be trading at 10,000-11,000 20 years from now."

stagflationary 1970s, when they lost ca. 23% in real terms.) And that's counting only the investors, managed funds, etc., which survived the decade. Not a few fell by the wayside during the crashes of 2001-2003 and 2007-2009; and those who did have likely fared much worse. The Nasdaq Composite fell about three quarters from its peak, and many tech stocks utterly disintegrated.

“If suffering builds character,” reported *USA Today* ([What Can Investors Learn from Dreary Decade?](#)) on 5 January 2010, “mutual fund investors have developed a lot of character in the past decade. Two soul-searing bear markets have sent investors reeling – and have severely tested the notion that the average person can save and invest enough to retire on her own.” What the bear market of 2000-2002 didn't shred, the bear market of 2007-2009 savaged. Both were more severe than 1973-1974, previously the worst since the Great Depression. The average fund gained 22.0% during the past decade, or an average 1.11% a year, despite a gain of 32% in 2009. (In sharp contrast, in the ten years to 31 December 1999 the average fund gained 353% and generated an annualised compound return of 15.7%.) Further, the ten funds into which investors poured the most money during 1999 – mostly “growth” funds – fell an average of 23% during the next ten years. Fidelity Growth Strategies, which experienced a net inflow of \$9.3 billion in 1999, plunged 67%. If you started 1999 with \$10,000 in the (say) Vanguard 500 Index fund and added \$100 per month, you'd now have approximately \$21,300 in your account – \$700 less than if you'd stuffed your money into a mattress.

The diversification of most portfolios spared many investors even worse carnage. Had you ploughed all of your money into Microsoft, the S&P 500's largest entity (by market capitalisation) in 1999, you'd now be down 35%, even with dividends reinvested. General Electric? Down 60%. General Motors? A virtual 100% loss. “Investors who bought stocks for the long run are finding out that the long run can be a long, long time. Just about anything beat the average stock fund the past 10 years: gold bullion (275%), government bond funds (70%), Treasury bills (30.5%). Even the consumer price index, the government's main gauge of inflation, stomped the average stock fund.”

It's vital to factor central banks' relentless destruction of the currency's purchasing power, together with the government's taxes and managers' fees, into one's long-term investment returns. According to *The Wall Street Journal* ([Adjusted for Inflation, Dow's Gains Are Puny](#), 27 December 2009), “despite its 2009 rebound, the Dow Jones Industrial Average today stands at just 10,520, no higher than in 1999. And that is without counting consumer-price inflation. In 1999 dollars, the Dow is only at about 8,200 and would have to rise another 28% or so to return to 1999 levels. Using today's dollars and starting at 10,520, the Dow would have to surpass 13,460 to reprise its 1999 level in real [CPI-adjusted] terms.”

In nominal terms, \$1 invested at the end of 1978 in a portfolio of stocks that mirrored the Standard & Poor's 500 would have blossomed to \$22.88 (including dividends) by the end of 2008. That's a compound rate of return of 11.0% per annum – a sweet gain even after the meltdown of 2007-2009. But after the effects

of inflation, taxes and typical fees, the \$1 grew to only \$3.76 – a compound rate of return of just 4.5% per annum.¹² American analysts often note (or should that be gloat?) that the level of the DJIA today is 27 times its level at the peak in 1929. That’s a nominal compound return of 4.7% per year. They infer from this result that time will heal the wounds even of investors who buy at the worst possible moment. (I’ve seen Australian financial planners and funds managers play the same trick with long-run charts of the All Ordinaries Index.) Yet according to Ned Davis Research, adjusted for CPI, taxes and fees, today’s Dow is only a little more than twice its 1929 peak – yielding a “real-real” compound return of ca. 1% per annum over 80 years. “Controlling for inflation takes extra work and makes stock gains look punier, so it is easy to see why stock analysts almost never do it. The media almost never do it either” (see also [Leithner & Company’s First Decade and Strategy for the Next Decade](#), Figure 5, p. 8).

As [Jim Hamilton](#) and [Stefan Karlsson](#) note, the Noughties were “a lost decade” in the U.S. (the phrase was originally used to describe [Japan from 1991-2000](#)) for the economy as well as for stocks. GDP, for example, grew at the weakest average pace since the 1930s. Karlsson lists America’s [growth](#) for different decades (adjusted for the terms of trade, Q4 to Q4, 2.8% annualised growth assumed for Q4 2009, compared to Q3 2009): 1950s (4.2%); 1960s (4.4%); 1970s (2.9%); 1980s (3.1%); 1990s (3.3%); 2000s 1.6%. Karlsson adds: “lower economic growth means that the potential for earnings growth will be limited as profits cannot in the long run grow faster than the overall economy. The lower rate of growth would imply that the P/E ratio should in fact be even lower than in the past, making stocks look even more overvalued.”

Yanks: Bullish a Decade Ago, Chastened Today; Aussies: Bullish Today ...

It’s easy to exaggerate, but hard to dispel: in some respects, attitudes in Australia in 2009-2010 resemble those that prevailed in the U.S. a decade ago. Most disturbingly, just as many Americans have long believed that the U.S. occupies a special niche among the nations of the world, that Americans have been uniquely favoured by Providence, etc. (the word that encapsulates these attitudes, “hubris,” has been cloaked in the academic phrase [American Exceptionalism](#)), it seems to me that during the past several years many Australians have come to believe that there exists in this country an exportable surplus of diplomatic, economic, financial, sporting and other expertise, and that the rest of the world is eager to receive it. Most laughably, the frenzied interventionism of the Commonwealth Government and RBA is apparently a model for central planners in other coun-

¹² “All of this might be enough to put investors off stocks entirely,” The *WSJ* notes, “until they consider the long-term alternatives. Measured over the 1978-2008 period, rather than over just one decade, stock performance in real terms [4.5% per year] actually is better than that of just about any other major investment class ... Stocks’ ability to keep up with inflation over the very long haul may be their best selling point. In real-real terms, stocks did better over that period than municipal bonds (2.5% a year), long-term government bonds (2% a year) and corporate bonds (0.2% a year). Real-real home prices were unchanged over those 30 years. Both short-term government bonds and commodities suffered losses.”

tries. According to *The Weekend Australian* (3-4 October 2009), “Australia’s recession-busting performance may provide a textbook case of how technocratic policy levers can steer an economy through shocks as big as the global financial crisis.”

Many Australians agree – not least because their rulers lose no opportunity to tell them – that they have barely survived an economic and financial near-death experience. For most, however, the pain and fear lasted but a moment and their severity was virtually inconsequential. In no sense did they experience what their forebears did during the 1930s. The Great Depression indelibly marked the attitudes of two generations; in sharp contrast, events since mid-2007 haven’t prompted Australians to become economically prudent and financially sensible to any measurable degree. Quite the contrary: these events have perversely encouraged them to resume even more risky behaviour (“Kevin Rudd and Julia Gillard and Wayne Swan will stimulate me if I run into trouble”). If, as many Australians apparently believe, governments can, should and will always rescue the over-indebted, over-leveraged and otherwise reckless, and heap the costs of the rescue upon the sober and prudent, then why on earth shouldn’t the crowd recommence without delay the bacchanalia of debt-fuelled expenditure?

Precisely because, after a brief hesitation early in 2009, the Australian crowd has returned to the economic and financial ways it learnt in the 1980s, 1990s and 2000s, it’s imperative that investors keep one point uppermost in mind: *those who didn’t see the Global Financial Crisis coming are now bullish about the future; in sharp contrast, the doughty few who anticipated trouble remain bearish.* It’s demonstrably false to say, as the mainstream does, that “nobody saw it coming;” what’s true, though, is that [those who saw it coming were and are, from a mainstream point of view, “nobodies.”](#) This doesn’t necessarily mean the prices of stocks, bonds and real estate will shortly fall sharply. Today’s unduly high valuations mean that long-term returns (say, for the next decade) will be relatively low. People who pay today’s prices for stocks, bonds and real estate and hold them for extended periods are likely to suffer meagre and perhaps even negative returns. They won’t necessarily encounter low or negative returns in the short term – for all I know, in 2010 they’ll continue to hit the jackpot. Alas, high short-term returns, if they occur, will eventually condemn the Australian crowd to long-term returns that are even worse than those they’d have received without the high short-term results.

In summary, then,

1. The probability that the All Ordinaries Index rises by at least 17% two years in succession (it rose 33% in 2009, and the crowd expects it to rise ca. 19% in 2010) is $0.20 \cdot 0.20 = 0.04$ or 4%. Two successive years of strongly above-average results occur, on average, only once every 20 years or so. Clearly, if investors take seriously the history of returns on the Australian stock market since the 1870s, and particularly the volatility of those returns from one year to the next, then the odds are rather strongly against today’s confident crowd.

2. The AOI beats a retreat – sometimes a sharp one – approximately 3 years out of every 10; more generally, returns from year to year are typically quite volatile. This combination (a negative return roughly one-third of the time, plus volatile returns most of the time) will conspire to compound Australian investors' capital at a much slower pace than the propaganda of the government and funds management industry – and the tyranny of average percentage returns – would have you believe.
3. Since late 2008, I believe, the earnings per share of the AOI have been regressing (and in 2010 I believe that they will continue to regress) to their 1974-2003 trend. For the crowd, this augurs poorly; for investors, it means that patience (and hefty caches of cash) will eventually be rewarded. What is a “fair value” for the AOI? What level provides an adequate “margin of safety”? I continue to believe it's closer to ca. 2,250 than to present levels.
4. I do not know if China's boom will share the same fate as the Internet and housing booms in the U.S.; but I suspect that, like all booms inflated by funny-money, it will fall well short of its boosters' exuberant claims.
5. A decade ago, many Americans were bullish to an almost insufferably arrogant degree about their country in general and its stock market in particular. Today, two recessions, two bear markets, two lost wars, one disgraced presidency and one bankrupt central government (and who knows how many broke states and municipalities) later, they are chastened. A decade ago, Australians looked with some envy towards the U.S. – after all, the latter was the centre of the Internet revolution, whereas Australia could offer the world nothing but dirt. Today, Australians prize their dirt – mostly because the rest of the world does – and regard it as an Open Sesame to decades of riches. But if all things have their season, then at some point Australians, too, will receive their comeuppance.

The Reputations of the High and Mighty, Too, Fall from Dizzy Heights

What's the greatest risk Australian that investors presently face? They don't properly acknowledge and incorporate into their plans – indeed, usually they completely overlook – the fact that small men with big egos and clay feet, advised by court economists with false ideas, govern Australia. Like Americans (see [The Misesian Vision](#) by Lew Rockwell), Australians are rapidly forgetting how to be free and losing the will to be free. At the moment the stock of Kevin Rudd is trading – figuratively – at forty times its earnings and five times its book. Why? Because many seem to believe – utterly astonishingly – that he is an economic saviour and a clairvoyant central planner. As *The Weekend Australian* ([PM Proves an Australian Winner in a Defining Year](#), 23-24 January 2010) fawned and gushed,

[In September 2008] the Rudd government ... was faced with a huge economic crisis ... Mr Rudd and his colleagues correctly saw it as a make-or-break moment for [the Australian Labor Party] – and for the country. Their response – to do whatever it took to ensure the economy did not go into a

technical recession¹³ – led to unprecedented levels of public spending ... We acknowledge the success of Mr Rudd’s strategy of pumping money to maintain consumer spending, protect employment and – perhaps just as importantly – to preserve domestic and international confidence in the economy. The strategy was risky, but the proof is in Australia’s success on a range of economic indices. With Wayne Swan, Finance Minister Lindsay Tanner and Deputy Prime Minister Julia Gillard at his side, the Prime Minister oversaw a recovery that amazed the world. Far from being mugged by the global financial crisis, Mr Rudd rose to the occasion and displayed the leadership qualities that have defined Australians of the Year since the award was launched almost 40 years ago ... [Mr Rudd’s determination] to navigate the GFC makes him an obvious choice as our Australian of the Year.

That’s one way of describing recent events. Another is that stupidity leads to socialism and [Socialism Leads to Stupidity](#) (see also [Letter 108-110](#) and [Letter 117-119](#)). If the problem is too much debt, then its solution is obviously to incur unprecedented amounts of additional debt. Eh? The more we spend, the richer we become. Come gain? If central banks’ control of short-term rates of interest has pushed them well below the level that would prevail in a free market, thereby encouraging consumers to borrow too heavily and to pay too much for real estate, etc., then the solution is clearly to intervene even more massively in credit markets, thereby pushing rates to even more artificially low levels and the prices of assets to even more artificially high levels. What on earth? If the benighted general public doesn’t borrow and spend as much as their enlightened rulers require, then the latter should do so – after all, each dollar of government expenditure magically multiplies itself as it circulates through the economy. As a result, we needn’t save in order to invest: the central bank will simply print the money that needs to be invested. Surely you’re joking?

All of this, of course, is utter nonsense that will have harmful consequences. Hence the reputations of the high and mighty, like the confidence of the crowd – and the body of Icarus – fall to earth after they rise to giddy heights.¹⁴ Like Poindexter today, Alan Greenspan, the former chairman of the U.S. Federal Reserve, enjoyed a dream run during his time. He, too, was once lauded for his allegedly Delphic wisdom and adept management of crises. On 19 January 2006, in a [Presentation to the Los Angeles Chapter, National Association for Business](#)

¹³ This assertion is, to put it mildly, very doubtful. See footnote #2 in Letter 120-123 for details.

¹⁴ *The Weekend Australian* (23-24 January 2010) implicitly acknowledged this point. It noted that “thirty-seven years ago, when Mr Whitlam was named our Australian of the Year, we said he had created ‘the feeling that from now on, the country’s affairs – at home and abroad – will be conducted with a new sense of purposeful direction and independence.’” To put it mildly, this hasn’t been Mr Whitlam’s legacy. “Thirty-two years ago, we said Mr Fraser ... had ‘put his personal stamp on the government and the direction of the country in a way that had hardly been equalled by any other prime minister since Menzies.’” Mr Fraser was a patrician interventionist and vacillator who proved unable to undo the damage of the Whitlam years – and added much damage of his own. Finally, “eight years ago we noted Mr Howard’s ‘admirable fighting qualities of tenacity, persistence and clever, disciplined aggression.’” Speaking of aggression, *The Weekend Australian* forgot to mention that [Mr Howard, along with George Bush and Tony Blair, are war criminals](#). The invasions of Iraq and Afghanistan have rightly stained their reputations; but do they torment their consciences?

[Economics](#), Janet Yellen, President of the Federal Reserve Bank of San Francisco, voiced this veneration:

As you know, 2006 is a year of significant transition for the Federal Reserve. At the end of this month, Alan Greenspan is stepping down as Chairman after 18 years of distinguished service ... So this seemed like a natural time to spend a few moments looking back at the Greenspan Fed and give you some of my views on what may lie ahead under a “Bernanke Fed.”

Alan Greenspan has won many plaudits for skilfully managing monetary policy – and deservedly so. During the Greenspan years, the U.S. economy has been extraordinarily stable, with just two mild and short recessions, and with low and stable inflation for over a decade. Clearly, in the short time I have today, I cannot do justice to all the accomplishments, innovations, and successes the Fed has achieved under his leadership. So I’ll focus on two aspects of policy that I believe have been especially important to this sterling record – a systematic, and therefore understandable and predictable approach to policy, and a growing emphasis on communication and transparency.

Since he retired, The Maestro’s halo has slipped.¹⁵ In particular, the extremely loose monetary policy – in a word, “stimulus” – he unleashed after the collapse of the Dot Com Bubble has been blamed for an explosion of ersatz credit, leading to (among other things) a bubble in residential lending and real estate markets and huge losses on sub-prime mortgages. Greenspan’s reputation in mainstream circles has been battered by the belated realisation that he, more than any single person, deserves the blame for the Global Financial Crisis. On 30 June 2009, Reuters ([Poll Finds Alan Greenspan to Blame for Credit Crisis](#)) reported that “Gary Jenkins, Head of Fixed Income Research at Evolution Securities, wanted a more specific scapegoat and ran a poll of about 200 mostly fund managers and investors asking them to pick their credit crisis culprit.” It continued:

Former U.S. Federal Reserve Chairman Alan Greenspan was the clear winner, picking up 35 percent of the votes. Once considered one of the world’s greatest central bankers, he has been widely criticized over the past year for low interest rate policies that helped fuel the credit boom.

¹⁵ On 26 February 2007, Mr Greenspan said that “it is possible we can get a recession in the latter months of 2007.” His musings contributed to a swift downdraught on stock markets. By 1 March, Mr Greenspan was backtracking – and perhaps brandishing the [Greenspan Put](#). Noting that a recession in 2007 was possible, he elaborated: “I don’t think it’s probable.” The Maestro wasn’t alone. “As a group, forecasters certainly don’t see a recession coming. On Feb. 13, those of the Federal Reserve Bank of Philadelphia collectively raised their estimates for real gross domestic product growth for 2007 to 2.8%, from 2.6%.” Further, “just because they’ve been wrong in the past doesn’t mean forecasters are wrong now. There is no reason at the moment why the steady momentum of the economy, with gains in employment feeding back into consumption growth, should falter,” said Robert J. Gordon, professor of economics at Northwestern University and a member of Business Cycle Dating Committee at the National Bureau of Economic Research (see Daniel Gross, [The Forecast of the Forecasters Is Dismal](#), *The New York Times*, 4 March 2007).

Jenkins himself suggested Microsoft founder Bill Gates take some blame for putting together the technology – spreadsheets and presentation software – that made it easy to create and sell the complex credit products that played a key role. “That’s a bit tongue-in-cheek,” he said. “If I had to choose one person I would choose Greenspan,” adding that of course it was unfair to blame one person. He said Greenspan’s reputation had rapidly switched from being one of the world’s leading economic thinkers to someone who helped cause the credit binge and bust. “He’s like a sporting star who’s gone from hero to zero,” said Jenkins. “He’s the Ronan O’Gara of central banking,” referring to an Irish rugby star who recently upset fans for bungling a tackle.

The Anointed Worsen the Ailment They’re Allegedly Trying to Cure

The welfare state of credit, like any welfare state, worsens the very disease it supposedly tries to cure. It fuels speculative frenzies in financial and investment markets, whilst attempting to prevent the losses associated with excessive risk taking. It thereby creates the boom that unleashes the bust, but attempts to abolish the bust. It can do so temporarily; alas, the interventions undertaken in order to avert the bust merely delays and eventually intensifies it. The long run consequence is to subsidise economic stagnation and financial instability in difficult-to-predict ways. The system has been designed to abolish crashes, but it accumulates the very extremes that inevitably beget crashes.

The purpose of buyers and sellers transacting voluntarily in markets, on the other hand, is to test the limits of ideas and correct extremes. In the 1980s, markets exposed the ridiculous extremes of corporate financial leverage – and unwound them in the recession of the early 1990s. In the late 1990s, they tested the outrageous extremes of the prices of stocks – and have been correcting them ever since. In the 2000s, they tested various bizarre extremes of residential lending, consumer credit and corporate financial engineering. In Britain and the U.S., but not (yet?) in Australia, the extremes of the Noughties have crashed back to earth. In order to obscure these old extremes’ causes and unintended consequences, new extremes are now appearing in governments’ finances and markets for sovereign debt. Actors in markets test limits and correct extremes, and I believe they will eventually find these new extremes just as unsupportable as the old ones.

The big question for investors,” said *The Wall Street Journal* (“The Profit and Pain of Stimulus,” 23 January 2010), “is how much of the market’s rebound was driven by improving fundamentals and how much by government stimulus. Some believe that healthy earnings will support U.S. stocks as long as any rate hikes are moderate and in response to real economic vigor. But last week’s China-driven action could be a taste of things to come if liquidity was the primary catalyst.”

Thanks allegedly to the world’s biggest central banks and governments, the effects of the Panic of 2007 were less calamitous than many had feared. So too – thus far – has been the Great Recession. But will the consequences of massive American, Chinese and other interventions enacted during the crisis render its aftermath more treacherous than most people expect? Today’s stability, after all, is quite

fragile. It depends upon the continued “stimulus” of governments, several of which (i.e., Britain, Japan and the U.S.) may be – or might before long be – insolvent. Further, the panic of rulers has obscured rather than solved the contradictions of the welfare state of credit – and has created new sources of volatility. Further, stresses in banking systems persist, and new eruptions – such as a sovereign default, a wave of defaults of commercial mortgages or a renewed crisis in residential mortgages – could cause the crowd to panic once again.

The trouble is that market participants, not least in Australia, are anticipating a swift return to “normal” conditions. But what they regard as “normal” are the extremes of the 1980s, 1990s and 2000s. The “abnormal” valuations that prevailed early in 2009 are actually – when viewed from a long-term historical perspective – “real normal.” In the “real normal” world, investors are free to make their own mistakes. Alas, in the “normal” world rulers encourage or even force subjects to repeat rulers’ mistakes. Rulers meddle in the economy and warp the financial picture. Investors thereby get the wrong ideas and learn the wrong lessons.

My view remains unchanged: before mid-2007, politicians’ crazed interventionism grossly distorted the economic and financial landscape; since then, they have continued to follow the advice of the very same caste of people who guided the economy to the precipice, and now threaten to push it over the edge. The crowd cheers today’s “stimulus” and artificially-low rates of interest – and clamours for more. They see stock and real estate markets that seemed so friendly and so rewarding for so long that they can’t imagine that they might ever be anything else. They observe a government prepared “to do whatever it takes” to avert the unintended consequences, namely recession and rising CPI and rates of interest, of its past policies. The crowd peruses *The Australian*, notes its choice of Australian of the Year and concludes that the political caste in Canberra can fix any problem it encounters.

Unfortunately, it has never learnt that politicians are economic illiterates who enter the stage, posture, pander and preen, utter their inanities and stupidities, do their damage and then retire to collect their “entitlements.” Their reputations rise and fall, but the damage they do, like an injured knee, never fully heals. I strongly suspect that the misplaced faith in the idol of the welfare state of credit (and the welfare-warfare state more generally) cements us into long-term secular (as opposed to short-term cyclical) stagnation. What’s certain is that a ramshackle collection of shifters, grafters, carpetbaggers and morons govern Australia. People and their rulers, I believe, are enthusiastically consuming rather than resolutely creating capital; as a result (and never mind the blissful ignorance), we’re in a recession. Even worse, few seem to know it, and the disparity between reality and perception augurs poorly for investors’ results. Worst of all, Australians’ poor understanding of how liberty works and why the state doesn’t means that our economic, financial and moral ailments will become chronic.

Chris Leithner